

Consistent with the large public company audit market, this practice is particularly prevalent in the initial public offering (IPO) arena, where an underwriter may include in the underwriting agreement a provision limiting the company's auditor choice to a specified group of auditing firms.<sup>132</sup>

Evidence suggests that auditor choice may be more limited among the largest IPOs: While midsize and smaller firms' combined share of the IPO market (by number of IPOs) has increased progressively (rising from 18% in 2003 to 40% in 2007),<sup>133</sup> the largest firms continue to audit the majority of the largest IPOs.<sup>134</sup>

The Committee believes these provisions impair competition by limiting public company auditor choice and the ability of smaller auditors to serve a greater share of the public company audit market. Accordingly, the Committee recommends that the Securities and Exchange Commission (SEC) require public companies to disclose any provisions in agreements limiting auditor choice. The disclosure should identify the agreement and include the names of the parties to the agreement and the actual provisions limiting auditor choice.<sup>135</sup>

(b) Include representatives of smaller auditing firms in committees, public forums, fellowships, and other engagements.

<http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Ferguson120307.pdf> ("Sometimes lenders, investors, investment bankers or credit rating agencies will insist that a company seeking to access the capital markets have its financial statements audited by one of the largest accounting firms, adding a bias that has the practical effect of being a barrier to entry.").

<sup>132</sup> See, e.g., Record of Proceedings (Feb. 4, 2008) (Oral Remarks of Brad Koenig, Former Managing Director and Head of Global Technology Investment Banking, Goldman Sachs, 219–220), available at <http://www.treas.gov/offices/domestic-finance/acap/Koenig020408.pdf> (noting underwriter practices in auditor selection). See also Edwin J. Kliegman, CPA, Comment Letter Regarding Discussion Outline 2 (Nov. 26, 2007).

<sup>133</sup> 2008 GAO Report 44.

<sup>134</sup> Record of Proceedings (Feb. 4, 2008) (Written Submission of Brad Koenig, Former Managing Director and Head of Global Technology Investment Banking, Goldman Sachs, 2), available at <http://www.treas.gov/offices/domestic-finance/acap/Koenig020408.pdf> (noting that from 2002–2007 the largest four auditing firms had an 87% market share of the 817 initial public offerings that exceeded \$20 million). See also 2008 GAO Report 44 ("Staff from some investment firms that underwrite stock issuances for public companies told [GAO] that in the past they generally had expected the companies for which they raised capital to use one of the largest firms for IPOs but that now these organizations were more willing to accept smaller audit firms \* \* \*. However, \* \* \* most of the companies that went public with a mid-size or smaller auditor were smaller. In addition, these firms' share of IPOs of larger companies (those with revenues greater than \$150 million) rose from none in 2003 to about 13 percent in 2007.").

<sup>135</sup> The Committee notes that a group of market participants put together by the United Kingdom's Financial Reporting Council to study audit market competition has suggested similar disclosure of contractual obligations limiting auditor choice. See Financial Reporting Council, FRC Update: Choice in the UK Audit Market 4 (Apr. 2007) [hereinafter FRC Update] (recommending that "when explaining auditor selection decisions, Boards should disclose any contractual obligations to appoint certain types of audit firms").

The Committee considered testimony that the lack of smaller firms' name recognition and reputation have hindered smaller auditing firms' ability to compete in the large public company audit market. The GAO noted that name recognition, reputation, and credibility were significant barriers to smaller auditing firm expansion.<sup>136</sup> The PCAOB has registered and oversees 982 U.S. auditing firms and 857 foreign auditing firms.<sup>137</sup> While it is not possible to include all smaller firms, the Committee received testimony and comment letters suggesting that there should be greater inclusion and participation of smaller firms in public and private sector committees, roundtables, and fellowships.<sup>138</sup> One auditing firm representative suggested the creation of a PCAOB professional practice fellowship program, reaching out to professionals from auditing firms of various sizes.<sup>139</sup>

The Committee believes increasing name recognition and reputation could promote audit market competition and auditor choice. Accordingly, the Committee recommends that regulators and policymakers, such as the SEC, the PCAOB, and the Financial Accounting Standards Board, include representatives of smaller auditing firms in committees, public forums, fellowships, and other engagements.<sup>140</sup>

Recommendation 2. Monitor potential sources of catastrophic risk faced by public company auditing firms and create a mechanism for the preservation and rehabilitation of troubled larger public company auditing firms.

<sup>136</sup> 2008 GAO Report 44 ("Fifty percent of accounting firms responding to [GAO's] survey that want to audit large companies said that name recognition or reputation with potential clients was a great or very great impediment to expansion. Similarly, 54 percent of these firms cited name recognition or credibility with financial markets and investment bankers as a great or very great impediment to expansion."). See also Edward J. Kliegman, Comment Letter Regarding Discussion Outline (Nov. 16, 2007).

<sup>137</sup> Data are as of Feb. 21, 2008.

<sup>138</sup> See, e.g., Andrew D. Bailey, Jr., Professor of Accountancy—Emeritus, University of Illinois, and Senior Policy Advisor, Grant Thornton LLP, Comment Letter Regarding Discussion Outline 16 (Jan. 30, 2008), available at [http://comments.treas.gov/\\_files/BAILEYCOMMENTS ONTREASURYADVISORYCOMMITTEE OUTLINEFINALSUBMISSION13008.doc](http://comments.treas.gov/_files/BAILEYCOMMENTS ONTREASURYADVISORYCOMMITTEE OUTLINEFINALSUBMISSION13008.doc); Record of Proceedings (Dec. 3, 2007) (Questions for the Record of James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, 4 (Feb. 1, 2008)), available at <http://www.treas.gov/offices/domestic-finance/acap/QFRs-12-3-2007.pdf>.

<sup>139</sup> Record of Proceedings (Dec. 3, 2007) (Written Submission of Wayne Kolins, National Director of Assurance and Chairman, BDO Seidman LLP, 4), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Kolins120307.pdf>. See Chapter V (recommending the creation of a PCAOB fellowship program). While maintenance and extension of professional fellowship programs are also considered in the Committee's recommendations relating to human capital matters, extending these opportunities increasingly to firms of various sizes could assist smaller firms in their ability to compete in the public company audit market.

<sup>140</sup> For a similar recommendation, see SEC Advisory Committee on Smaller Public Companies, Final Report 114 (Apr. 23, 2006).

The Committee considered testimony regarding the variety of potentially catastrophic risks that public company auditing firms face. These risks include general financial risks and risks relating to failure in the provision of audit services and non-audit services, including civil litigation, regulatory actions, and loss of customers, employees, or auditing network partners due to a loss of reputation.<sup>141</sup>

The Committee believes these risks are real and notes that over the past two decades two large auditing firms have gone out of existence. In 1990, Laventhol & Horwath, at the time the seventh largest auditing firm in the United States, filed for bankruptcy protection due in part to a failure in the provision of non-audit services, and subsequent class action litigation, loss of reputation, and inability to attract and retain clients.<sup>142</sup> In 2002, Arthur Andersen, at the time one of the five largest auditing firms in the United States, dissolved. The Department of Justice (DOJ) had criminally indicted the auditing firm on obstruction of justice charges relating to the audit of Enron. The resulting inability to retain clients and partners and keep together its global affiliate network led to the collapse of Arthur Andersen.<sup>143</sup>

In addition, KPMG recently faced the possibility of criminal indictment relating to its provision of tax-related services. In the end, KPMG entered into a deferred prosecution agreement with the DOJ.<sup>144</sup> Many have suggested that a criminal indictment would have led to the dissolution of the firm.

Currently, BDO Seidman is appealing a \$521 million state judgment involving a private company audit client. The auditing firm's chief executive has publicly stated that

<sup>141</sup> See, e.g., 2008 GAO Report 32–36; Zoe-Vonna Palmrose, *Maintaining the Value and Viability of Independent Auditors as Gatekeepers under SOX: An Auditing Master Proposal*, in Brookings-Nomura Seminar: After the Horses Have Left the Barn: The Future Role of Financial Gatekeepers 12–13 (Sept. 28, 2005). Civil litigation was the risk most often cited by witnesses before the Committee. See, e.g., Record of Proceedings (Dec. 3, 2007) (Written Submission of James D. Cox, Brainerd Currie Professor of Law, Duke University School of Law), available at <http://www.treas.gov/offices/domestic-finance/acap/submissions/12032007/Cox120307.pdf>. See also Eric R. Talley, *Cataclysmic Liability Risk among Big Four Auditors*, 106 Colum. L. Rev. 1641 (Nov. 2006) ("On one hand, the pattern of liability exposure during the last decade does not appear to be the type that would, at least on first blush, imperil the entire profession. On the other hand, if one predicts historical liability exposure patterns into the future, the risk of another firm exiting due to liability concerns appears to be more than trivial.").

<sup>142</sup> See, e.g., 2008 GAO Report 33.

<sup>143</sup> See, e.g., U.S. Government Accountability Office, *Public Accounting Firms: Mandated Study on Consolidation and Competition 12* (July 2003) ("The criminal indictment of fourth-ranked Andersen for obstruction of justice stemming from its role as auditor of Enron Corporation led to a mass exodus of Andersen partners and staff as well as clients.").

<sup>144</sup> 2008 GAO Report 56–57, n. 60. Note that the Department of Justice did indict several individuals.